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November 15, 2004

Mr. Keith Rake
Deputy Assistant Commissioner
Bureau of the Public Debt
Department of the Treasury
200 3rd St.
Parkersburg, WV 26101

In regard to Docket Number BPD-02-04

Dear Mr. Rake:

The Bond Market Association (the "Association") is pleased to provide comments on the Bureau of the Public Debt's (the "Bureau") Notice of Proposed Rulemaking (the "Proposal") published in the Federal Register on September 30, 2004 to revise regulations governing State and Local Government Series securities ("SLGS"). The Bond Market Association, with offices in New York, Washington, D.C. and London, represents securities firms and banks that underwrite, trade and sell debt securities and other financial products globally. Our membership includes all major underwriters of municipal securities.

The Association's members play a significant role in state and local governments' use of SLGS. In many cases, municipal bond underwriters advise issuers with regard to their purchases of SLGS and assist their state and local clients in structuring and restructuring bond escrow portfolios using both SLGS and marketable Treasury securities. In general, we believe the SLGS program operates efficiently and soundly. We do not believe wholesale changes to the program are warranted at this time. We also believe that eliminating certain features of the SLGS program would effectively impose substantial costs on states and localities because certain of those features have a significant market value. Indeed, we believe that the value associated with certain SLGS features proposed for elimination almost surely exceeds the $100 million threshold of a "significant regulatory action" as defined in Executive Order 12866. However, we are sympathetic to concerns the Bureau raised in the Proposal regarding excessive administrative burdens brought about by how the SLGS program currently operates as well as concerns related to features of the program which permit issuers to take undue advantage of market movements. Our comments are intended to provide constructive input on how the SLGS program can be amended to address the Bureau's most problematic concerns without making the program unattractive to state and local governments.

It is in the Treasury Department's interest to offer a SLGS program that is as flexible and attractive as possible for state and local government bond issuers. Before the current version of the SLGS program was put in place in 1996, SLGS were an extremely unattractive option for the escrow portfolios of states and localities. Consequently, the vast majority of issuers were driven to use open market escrows, resulting in significant problems related to compliance with and enforcement of the tax-exempt bond arbitrage provisions of the tax code. It would be against Treasury's interest to push a substantial number of issuers away from SLGS in the direction of open market escrows by making the SLGS program unattractive.

In that vein, we offer the following comments on specific provisions of the Proposal.

Proposal to make SLGSafe mandatory for all transactions

The Association strongly supports the provision of the Proposal that would require all tax-exempt bond issuers to submit and manage their SLGS transactions through SLGSafe. We believe that this provision alone will do much to alleviate the administrative burden experienced by the Bureau in processing numerous subscriptions, cancellations and amendments submitted by fax or through the mail.

We would recommend one technical change to this provision of the Proposal. The Proposal would mandate that issuers submit certifications required for redemptions before maturity through SLGSafe. However, it is often the case that issuers themselves are not the ones accessing SLGSafe to manage accounts, but rather the issuers' agents. We recommend that the Proposal be amended so that subscribers, rather than issuers, submit required certifications.

Prohibition on purchasing SLGS with maturities longer than necessary

The Association generally supports this proposal. We do not believe it will unduly restrict the use of the SLGS program. However, we recommend a clarification that issuers may purchase SLGS of maturities necessary to escrow outstanding municipal bonds to their maturity if desired, not only their call date.

Amend SLGS regulations to allow better pricing methodologies for long-dated SLGS

The Association supports this proposal. We believe Treasury should have the flexibility to improve pricing methodologies for long-dated SLGS should circumstances warrant.

Limiting hours for SLGS subscriptions to 10 a.m. to 6 p.m. eastern time

The Association does not necessarily oppose the establishment of firm hours for SLGS subscriptions. However, we believe that 6:00 p.m. eastern is far too early to close the SLGS window, particularly for issuers on the west coast, including Alaska and Hawaii.

We recommend that the Bureau permit SLGS transactions through SLGSafe from 10 a.m. to 12 midnight eastern time.

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It is often the case that for bond transactions involving SLGS, municipal bonds being sold by states and localities are priced by underwriters during the course of the business day. After a full day of interacting with investors and establishing offering prices, it is possible to size the issue, determine acceptable escrow yields and determine the issuer's SLGS subscription amount. However, even for east coast issuers, this process is not completed until well into the evening in many cases. Allowing issuers extra time to determine their SLGS subscription amounts will help ensure that subscriptions submitted by issuers are accurate. For west coat issuers, the proposal is even more problematic. It is practically impossible at 3:00 p.m. local time for issuers in the Pacific time zone, 2:00 p.m. for issuers in Alaska and noon for issuers in Hawaii to effectively price and size their bond issues and determine their SLGS subscriptions to meet the proposed closing time for the SLGS window. In addition, some market participants have suggested that waiting until 10:00 a.m. to open the window would be a burden for some issuers. Finally, with the provision to mandate the use of SLGSafe for all SLGS transactions, keeping the SLGS window open until midnight eastern should not present a significant administrative burden.

Requirement for issuer certification that bonds are "authorized"

The Proposal includes a provision which would require subscribers to certify that the issuance of their bonds has been "authorized" as a condition for submitting a SLGS subscription. However, the "authorization" of a bond issue is in many cases a formal act which often does not take place until near the end of the issuance process. In some cases, authorization requires the act of a legislative body or other public body. Forcing issuers to wait until bonds are authorized to subscribe for SLGS is an unreasonable requirement.

We recommend that the Proposal be amended to require subscribers to certify that they have a "reasonable expectation" that bonds will be issued as a condition of a SLGS subscription. The "reasonable expectation" standard is consistent with timing requirements under the tax-exempt bond arbitrage rules.

Prohibition on using the proceeds of early SLGS redemptions or sales of marketable securities to invest in higher-yielding SLGS

A key provision of the Proposal would prohibit issuers from investing the proceeds from the early redemption of SLGS or the sale of marketable securities into higher-yielding SLGS. The Proposal would also prohibit the early redemption of SLGS in cases where the issuer was using the redemption proceeds to invest in higher yielding marketable securities. The Association is sympathetic to concerns associated with redeeming SLGS early in order to invest in higher-yielding SLGS—SLGS-to-SLGS escrow restructuring transactions. However, we believe that transactions where issuers redeem SLGS early to invest in marketable securities or sell marketable securities to invest in SLGS should

continue to be permitted. There is a fundamental difference between SLGS-to-SLGS transactions and escrow restructurings into or out of marketable securities.

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In the case of SLGS-to-SLGS transactions, the early redemption of SLGS and the reinvestment of redemption proceeds in higher-yielding SLGS results in a circumstance where lower-yielding debt of the federal government—the SLGS being redeemed early—must be replaced with higher-yielding debt at a cost to taxpayers. However, in cases where issuers sell marketable securities to invest in higher-yielding SLGS, the Treasury's borrowing cost associated with the outstanding marketables, locked in when the securities were issued to the public at auction, is not affected. Indeed, such a transaction arguably saves taxpayers money, because it allows Treasury to issue lower-yielding SLGS rather than higher-yielding marketable securities to meet its funding needs.

Similar factors are at play in SLGS-to-marketable escrow restructuring transactions. When an issuer redeems SLGS early to invest the proceeds in marketable securities, the transaction does not result in an instance where Treasury must issue higher-yielding securities to satisfy the issuer's subscription, as in the case of SLGS-to-SLGS transactions. Moreover, in some cases, the higher yield achieved by redeeming SLGS early to invest in marketables is associated with buying securities with a higher degree of credit risk than Treasuries, such as Refcorp or USAID bonds, rather than by market movements. In addition, mandating the use of SLGSafe for all SLGS transactions will substantially reduce the administrative burden associated with early redemptions of SLGS and new SLGS subscriptions.

In sum, we urge Treasury to amend the Proposal to allow higher-yielding SLGS subscriptions in cases where issuers are restructuring escrows out of marketable securities. In addition, we urge Treasury to permit the early redemption of SLGS in cases where issuers are restructuring escrows into higher-yielding marketable securities.

Prohibition on cancellation of SLGS subscriptions

The Association strongly opposes the provision in the Proposal to prohibit the cancellation of SLGS subscriptions except when "the cancellation is required for reasons unrelated to the use of the SLGS program to create a cost-free option."

When the current SLGS program was put in place in 1996, it was designed, with extensive input from issuers, dealers and other market participants, to provide issuers with an attractive alternative to open-market escrows. A key feature of the program is the ability of issuers to cancel SLGS subscriptions within 60 days and to resubscribe at current market rates. The Association recognizes that this feature represents a valuable option for municipal bond issuers, but that value was included in the program by design to induce issuers to use SLGS rather than marketables. In addition, issuers do, indeed, pay a price for using SLGS in the form of the five basis point reduction in yield associated with using SLGS rather than marketables. This reduction in yield partly covers the cost of the cancellation option.

Prohibiting issuers from canceling and resubscribing for SLGS would have the effect of transferring to issuers a significant degree of market risk which does not exist in the current program. The cancellation option represents significant value, and eliminating it would make SLGS substantially less attractive for state and local governments relative to marketable securities. It would drive a significant number of issuers to the use of marketables for their escrow needs. This, we believe, is counter to Treasury's interests and counter to the goals embodied in the 1996 amendments to the SLGS program. Creating incentives for issuers to use marketables rather than SLGS would also create additional enforcement burdens for Internal Revenue Service personnel that help ensure issuer compliance with municipal bond arbitrage rules.

One of the arguments offered by the Bureau for eliminating the cancellation option is the administrative burden presented by numerous cancellations and resubscriptions. This issue would be substantially addressed, however, by the elimination of paper subscription forms and the mandatory use of SLGSafe.

Moreover, we believe that the cancellation option included in the current program has a significant value for states and localities. The value almost certainly exceeds the $100 million threshold established in Executive Order 12866 as a characteristic of a "significant regulatory action." Eliminating a program feature with such a significant value for states and localities is, we believe, unjustified.

Requirement that changes in subscriptions for Time Deposit SLGS may not exceed ten percent of the subscription amount

Under current rules, an issuer purchasing time deposit SLGS may amend its subscription amounts by the greater of $10 million or ten percent of the subscription amount. Under the Proposal, changes could not exceed ten percent of the subscription amount. The $10 million floor would be eliminated.

The Association opposes this proposal because it would take away from issuers a considerable degree of flexibility in structuring their escrow accounts and would disproportionately affect smaller state and local issuers. The Proposal would constrain the ability of issuers to amend their subscriptions in legitimate circumstances, and would make the program less attractive to issuers. Despite our opposition, however, we are sensitive to concerns raised by the Bureau that excessive changes in subscription amounts make it more difficult to project cash flow and financing needs. Therefore, we suggest that the Bureau retain the subscription amendment provision in current rules—the greater of ten percent or $10 million—but apply the ten-percent calculation to all SLGS subscriptions pending by the issuer at the time the change in subscription amount is requested.

Prohibition on amending the issue date for SLGS subscriptions

Under current rules, issuers may extend the issue date for Time Deposit SLGS by up to seven days after the date specified in the original subscription request. The Proposal

would eliminate this feature and require that all SLGS be issued on the date originally specified in the subscription.

THE BOND MARKET ASSOCIATION

The Association opposes this proposal because it would take away from issuers a considerable degree of flexibility in the use of SLGS and would make the program less attractive to issuers. There are numerous legitimate reasons why issuers may need to extend the delivery date of their SLGS. In structuring and marketing new municipal bonds, countless factors can delay transaction settlements. The current feature which permits extensions of time to take delivery of SLGS helps issuers adapt to delays that may occur in bringing new issues to market. We urge the Bureau to drop the provision from the Proposal.

Requirement that only the gross proceeds of tax-exempt bonds can be invested in SLGS

Under current rules, issuers can buy SLGS with any source of funds as long as the SLGS are purchased to help comply with tax-exempt bond rules. The Proposal would prohibit issuers from using any sources of funds other than the gross proceeds of a bond issue to purchase SLGS and may, depending upon its interpretation, preclude the investment of the proceeds of taxable bonds. We oppose this provision as an unnecessary burden on issuers. Moreover, we believe the provision would be contrary to the interests of the Treasury by discouraging issuers from using SLGS for moneys other than proceeds of tax-exempt bonds.

It is not uncommon to encounter circumstances in which moneys that are not initially gross proceeds of a tax-exempt bond issue may become proceeds of the issue at a future time. Consider, for example, a $100 million new money financing, sold at par, for a university which uses endowment moneys to fund a $10 million debt service reserve fund. Although moneys in an "equity funded" reserve fund are a classic example of replacement proceeds under Treas. Reg. §1.148-1(c)(3), ignoring costs of issuance and assuming that $100 million is deposited in the construction fund, no portion of the reserve fund moneys would be initially treated as bond proceeds as a result of the "universal cap" rules of Treas. Reg. §1.148-6(b)(2). Under the Proposal, it appears that such funds would not be eligible for investment in SLGS. However, as construction fund moneys are expended, the investments in the debt service reserve fund would become proceeds of the issue. Under Treas. Reg. §1.148-5(d)(3)(i), as the investments in the reserve become proceeds of the issue, the investments must be valued at fair market value for subsequent yield and rebate calculation purposes, resulting in an unpredictable, higher or lower yield than the cost-based yield realized by the university as an economic matter. If interest rates have risen, the university suffers a double loss: (i) the fair market value of the reserve fund investments will have declined and (ii) the constructive yield on the investments will be higher, resulting in increased arbitrage rebate liability. In order to avoid this result, under current rules, the university could invest the reserve fund moneys in SLGS and take advantage of a provision in the arbitrage regulations, Treas. Reg. §1.148-5(d)(6)(i), that provides that the fair market value of a security purchased directly from the Treasury is its purchase price. If the Proposal is adopted in its current form, the

university in the example would have incentive to increase the size of the bond issue and fund the reserve fund from bond proceeds to the disadvantage of the Treasury.

If the Proposal modifies this portion of the rules in any respect, the modification should expressly permit investment of the gross proceeds of taxable bonds in SLGS. The Treasury should be encouraging issuers to access the taxable markets, not impeding the use of taxable bonds as a financing tool.

Conclusion

Since it was substantially amended in 1996, the SLGS program has been an important and useful tool for state and local governments in managing investments related to compliance with tax-exempt bond rules. The success of the program is attributable to key features that provide value for states and localities such that SLGS have become, in the vast majority of cases, more attractive than marketable securities for tax-exempt bond escrows. This is precisely the effect intended when the 1996 changes were adopted.

Stripping some of the most important features from the SLGS program—the ability to cancel SLGS subscriptions and re-subscribe as market conditions warrant, or the ability to redeem SLGS early to restructure escrows, for example—would make the program significantly less attractive for issuers. Some of the proposed changes would have the effect of driving issuers away from SLGS in favor of open-market escrows. This would not be in the interest of the Treasury Department or American taxpayers. We urge Treasury to weigh carefully the potential effect of the proposed changes on issuers' investment decisions and to temper the Proposal in keeping with our comments.

We appreciate the opportunity to submit our views, and we would be happy to provide additional information and perspective if desired.

Sincerely,

John R. Vogt
Executive Vice President